



OFFICE OF  
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DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
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MEMORANDUM FOR  
ARC-GL CC:MSR:GL

FROM:  
Acting Assistant Chief Counsel (Income Tax & Accounting)

SUBJECT: Oklahoma City Bombing Disaster Relief

This Technical Assistance is in response to your request for assistance dated April 15, 1998 regarding the tax treatment of government payments made to taxpayers to repair or replace property damaged as a result of the bombing of the Alfred P. Murrah Federal Building in Oklahoma City on April 19, 1995. These payments were made pursuant to the "Chamber Grant" program and Phases I and II of the Community Development Block Grant (CDBG) Program. Technical Assistance does not relate to a specific case and is not binding on Examination or Appeals. This document is not to be cited as precedent.

**ISSUES:**

- 1) Did taxpayers owning property that was damaged or destroyed by the bombing have a claim for reimbursement to which there was a reasonable prospect of recovery in 1995?
- 2) Under § 1033, may taxpayers defer recognition of gain realized on payments received under the Oklahoma City bombing disaster relief measures?

**CONCLUSIONS:**

1) Taxpayers who met the stated program criteria and were eligible to apply for a Chamber Grant in 1995, had a claim for reimbursement and a reasonable prospect of recovery in 1995 and were not entitled to a deduction under § 165 to the extent of the expected recovery. Taxpayers also had a claim for reimbursement and a reasonable prospect of recovery in 1995 under Phase I of the CDBG program and were not entitled to a deduction under § 165 to the extent of the expected recovery. If taxpayers improperly deducted the casualty loss in 1995 they should amend their 1995 returns to eliminate the casualty loss deduction.

Oklahoma City did not approve Phase II of the CDBG program until 1996. Thus, taxpayers applying for funds under Phase II did not have a claim for reimbursement and a reasonable prospect of recovery in 1995 and could deduct losses for 1995 under § 165.

2) Under § 1033, taxpayers may defer recognition of gain realized on payments received under the Chamber Grant Program and Phase I of the CDBG program, and payments received under Phase II as compensation for bomb damage, if taxpayers otherwise comply with the provisions of that section. Gain realized on payments received under Phase II to stimulate economic recovery and community revitalization may not be deferred under § 1033.

Property owners who properly claimed a casualty loss deduction under § 165 in 1995 and who subsequently received reimbursements for property damaged or destroyed by the bombing should recognize ordinary income in the year the reimbursement was received to the extent that the deduction resulted in a tax benefit in a prior year. Any gain attributable to the reimbursement in excess of the recognized ordinary income may be deferred under § 1033.

**FACTS:**

Oklahoma City was declared a disaster area following the bombing of the Alfred P. Murrah Federal Building on April 19, 1995. To reimburse property owners for uncompensated property losses attributable to the bombing, Oklahoma City made grant funds available to property owners from two sources. The first \$600,000 fund was made available through the Small Business Grant Assistance Program (the Chamber Grant Program), and the second, through the \$39 million supplemental appropriation administered as the CDBG program. The Chamber grants were originally provided in the form of forgivable loans and were disbursed by the Chamber of Commerce. These were provided as an emergency measure immediately after the bombing and before Congress had allocated emergency relief funds in the form of the \$39 million supplemental CDBG program. Once the

supplemental allocation was made available to Oklahoma City, the Chamber loans were converted to grants with CDBG funds.

A property owner could have applied for and received up to \$10,000 per property in 1995 under the Chamber Grant Program. The City maintained the option to deny a Chamber Grant application and consider the request under the \$39 million supplemental appropriation when those funds became available.

Congress specifically provided the \$39 million supplementation "...to assist property and victims damaged and economic revitalization due to the bombing of the Alfred P. Murrah Federal Building..." This program consisted of two phases.

On November 14, 1995, the City enacted Phase I of the bombing recovery program. Phase I addressed the need for repairs, primarily external repairs, to buildings and property damaged by the bombing, limited to \$20,000 per property. The intent was solely to return damaged properties to their pre-bomb condition. Grant funds were provided only to pay that portion of damages uncompensated by other sources. For example, if an affected property owner was partially compensated through donations or other sources directed towards correction of bomb damages, the property owner was only eligible for this funding to the extent of damages not otherwise covered. Similarly, if a property owner was insured, the owner was eligible for grant funds only to the extent of the deductible amount, if any, or the difference between the insurance settlement amount and the actual cost of repairs.

On January 16, 1996 the City enacted Phase II of the CDBG program. The objectives of Phase II were to provide additional funds for bomb-damage reimbursements and to revitalize the affected area by attracting new businesses and encouraging the expansion of existing businesses. Property owners with damage claims in excess of \$20,000 could submit a claim for grant funds under Phase II of the program. Phase II also made loans available to property owners for the purpose of revitalizing the downtown area.

The property damage reimbursement phases of the CDBG program generally operated as follows. Bomb affected property owners and businesses submitted applications to the City for assistance. Damages were assessed by a consultant Architecture and Engineering firm on contract to the City. The firm's report, together with any eligible requirements for work already done (emergency repairs) was reviewed by a committee composed of senior City officials and the Executive Director of the Urban Renewal Authority. Based on their review, the Committee made a recommendation for funding to the Mayor and City Council. Once approved by the Council, checks were issued for reimbursement and /or the owner was authorized to hire an architect to prepare plans and specifications to address the approved repairs. Bids were taken on unrepaired damages and work undertaken in accordance with the recommended scope of repairs. No enhancements to

damaged properties were funded by the grants except as required to comply with current life/safety Code requirements. Only verified property damage was addressed under this program.

## **LAW & ANALYSIS:**

### **Section 165**

Section 165(a) generally provides a deduction for any loss sustained during the taxable year and not compensated for by insurance or otherwise. Government funds earmarked to reimburse taxpayers for property damage attributable to a casualty constitute "compensation" within the meaning of § 165(a). See e.g. Londagin v. Commissioner, 61 T.C. 117 (1973) (Federal and State funds used to reduce SBA mortgage balances on property damaged in an earthquake); Spak v. Commissioner, 76 T.C. 464, 467 (1981) (use of government funds to purchase flood-damaged property for an amount in excess of post casualty fair market value); Rev. Rul. 71-160, 1971-1 C.B. 75; Rev. Rul. 74-206, 1974-1 C.B. 198.

Treas. Reg. § 1.165-1(d)(2)(i) provides in part:

If a casualty or other event occurs which may result in a loss and, in the year of such casualty or event, there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss with respect to which reimbursement may be received is sustained, for purposes of section 165, until it can be ascertained with reasonable certainty whether or not such reimbursement will be received.

As noted above, the regulation requires both a claim and a reasonable prospect of recovery as a prerequisite to the denial of a loss. The regulation does not define the meaning of the term "claim." Moreover, the question of when a taxpayer has a claim under a governmental disaster relief program appears to be an issue of first impression.

We believe the term "claim" as used in the regulation should be interpreted to include rights to payment under a funded<sup>1</sup> government program. In our view, a claim arises when a government program has been created that has criteria for qualification thereunder that allows intended beneficiaries of the program to identify

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<sup>1</sup> For this purpose a government program is funded when the necessary money has been appropriated to implement the program.

themselves with reasonable certainty, and also provides the procedural steps, if any, that such beneficiaries must follow to assert their claims. That a taxpayer's actual right to payment might prove contingent under the government program's terms does not mean there is no claim. Rather, that factor becomes relevant only to the issue of whether a taxpayer has a reasonable prospect of recovering on the claim.

### Chamber Grants

We conclude that a taxpayer meeting the stated program criteria, and therefore eligible to apply for a Chamber Grant in 1995,<sup>2</sup> had a claim for reimbursement within the meaning of Treas. Reg. § 1.165-1(d)(2)(i) for that year unless the claim was denied in 1995. The next issue to be resolved concerns whether such a taxpayer also had a reasonable prospect of recovery on that claim in 1995.

Obviously, a taxpayer actually approved for a Chamber Grant in 1995 had a reasonable prospect of recovery under the Chamber Grant Program in that year. However, we believe that any taxpayer eligible to apply for a Chamber Grant in 1995, but not actually approved for such grant in that year, also had a reasonable prospect of recovery under the program in 1995. Although an applicant for a Chamber Grant had no assurance of receiving such a grant, the amount of money appropriated for the Chamber Grant program gave those eligible to apply at least a reasonable prospect of recovery under the program. Thus, losses reimbursable or eligible for potential reimbursement under the Chamber Grant Program should not be allowable deductions for 1995. Taxpayers who improperly claimed the deduction in 1995 should amend their 1995 returns to eliminate the casualty loss deduction so that taxable income is accurately reflected for the year.

### The \$39 Million Supplemental Appropriation

As discussed, the City implemented the \$39 million supplemental appropriation for the purpose of reimbursing uncompensated property losses attributable to the

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<sup>2</sup> Section 165(i) provides a special rule for a loss attributable to a disaster occurring in an area subsequently determined by the President of the United States to warrant assistance under the Disaster Relief and Emergency Assistance Act. A taxpayer who meets certain requirements may elect to deduct such a loss for the taxpayer's taxable year immediately preceding the taxable year in which the loss occurred. The City was declared such a disaster area as a result of the bombing. See Rev. Rul. 96-13, 1996-1 C.B. 18, 21. For convenience we have assumed bombing losses will be claimed for 1995 although some taxpayers may be entitled to such losses for 1994 under section 165(i). In any event, a loss must meet all criteria for allowance for 1995 to be eligible for allowance for 1994 under section 165(i).

bombing in two phases: (1) Phase I which the City approved in 1995, and (2) Phase II which the City did not approve until 1996. Damages reimbursable under Phase I were generally limited to \$20,000 per property and the amount of funds available for Phase I appears to have been more than adequate to reimburse the qualifying damages up to the per property limit. Thus, a taxpayer who had property damage reimbursable under Phase I had, in 1995, both a claim for reimbursement and a reasonable prospect of recovery on that claim. Therefore, such losses did not qualify for deduction under section 165(a) for 1995. Taxpayers who improperly claimed the deduction in 1995 should amend their 1995 returns to eliminate the casualty loss deduction so that taxable income is accurately reflected for the year.

Because the City did not approve Phase II (under which uncompensated bombing damage to property in excess of \$20,000 became reimbursable) of the recovery program until 1996, no taxpayer had a claim under Phase II of the program at the end of 1995. Therefore, uncompensated property losses reimbursable under Phase II, and meeting any other requirements for deductibility, constitute allowable deductions under section 165(a) for 1995. Because the casualty loss deductions were proper, taxpayers that received reimbursements under Phase II for their losses may have had gross income in subsequent years under the tax benefit rule, as explained below.

### **Section 1033**

Section 1033(a) of the Code provides, in part, that if property, as a result of its destruction in whole or in part, is involuntarily converted into money or into property not similar or related in service or use to the converted property, the gain, if any, shall be recognized except to the extent that the electing taxpayer, within two years after the close of the first taxable year in which any gain was realized, purchases other property similar or related in service or use to the property so converted. In that event, the gain shall be recognized only to the extent that the amount realized upon such conversion (regardless of whether such amount is received in one or more taxable years) exceeds the cost of such other property.

Section 1033(b)(2) provides that if property is converted into money, and the taxpayer purchases qualified replacement property and elects nonrecognition of gain under § 1033(a)(2), then the basis of the replacement property shall be the cost of such property decreased by the amount of gain not recognized.

Section 1.1033(b)-1(b) of the Income Tax Regulations provides an example; assume A realizes \$22,000 from the involuntary conversion of his barn in 1955; the adjusted basis of the barn to him was \$10,000 and he spent in the same year \$20,000 for a new barn which resulted in the nonrecognition of \$10,000 of the \$12,000 gain. The basis of the new barn to the taxpayer would be \$10,000— the cost of the new barn (\$20,000) less the amount of the gain not recognized on the conversion (\$10,000).

Property that was damaged or destroyed by the bombing was involuntarily converted “as a result of its destruction in whole or in part” for purposes of § 1033.

Accordingly, taxpayers who received grants under the Chamber Grant or the CDBG programs that were provided for the purpose of compensating owners of property damaged or destroyed by the bombing were eligible to defer recognition of the gain realized if they otherwise complied with the provisions of § 1033. On the other hand, gain realized on a loan provided under Phase II of the CDBG program for the purpose of stimulating economic recovery and community revitalization, rather than for the purpose of compensating property owners for bomb damage to their property, may not be deferred. For taxpayers that received grants eligible for deferral under § 1033, expenditures made to repair or replace damaged property are treated as amounts spent to purchase qualifying replacement property, including expenditures for the following items:

- (1) Removal of trash and debris;
- (2) Abatement of weeds, unsightly bushes, damaged or dying trees;
- (3) Demolition of structures which have lost structural integrity; and
- (4) Securing of retained structures through replacement of doors and installation of temporary windows.

An additional consideration is the application of the tax benefit rule, which ordinarily requires the recognition of gross income in cases where a taxpayer has properly deducted a loss on a federal income tax return, derived a tax benefit from the deduction, and then received compensation for the loss in a subsequent year. Hillsboro Nat'l Bank v. Comm'r, 460 U.S. 370 (1983), 1983-1 C.B. 50. The compensation is includible in gross income to the extent of the tax benefit derived from the deduction of the loss in the prior year. Id.; § 111, Recovery of Tax Benefit Items; Treas. Reg. § 1.165-1(d)(2)(iii). However, when the compensation qualifies for nonrecognition from gross income under another provision of law, for example, § 1033, a tension must be resolved between the inclusion required by the tax benefit rule and the nonrecognition allowed. Hillsboro, 460 U.S. 370. With respect to reimbursements under Phase II of the CDBG program, the nonrecognition allowed under § 1033 is overridden to the extent of the tax benefit derived from the § 165 deduction claimed in a prior year. See Rev. Rul. 74-206, 1974-1 C.B. 198. Thus, taxpayers that properly claimed a casualty loss deduction under § 165 in 1995 and subsequently received reimbursements for their losses should include the reimbursements in gross income in the year received to the extent the deduction resulted in a tax benefit. Section 1033 and the tax benefit rule do not apply, however, to the extent of funds disbursed under Phase II (whether as grants or loans) for the purpose of economic revitalization. We have not been asked and express no opinion, about the proper tax treatment of disbursements under Phase II

that were not strictly limited to compensating property owners for uncompensated property losses attributable to the bombing.

**CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS:**

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